

BUSINESS

LAW TODAY

THE MAGAZINE OF THE ABA SECTION OF BUSINESS LAW

By IAN RATNER



Fraud by the numbers

Slug Signorino

Have you seen your

forensic accountant lately?

The assault on your corporate clients' bottom line is harsh and unrelenting. Increasing competition, low-cost foreign manufacturers, increasing wages, health-care costs, taxes and the combined effect of low prices and a fickle marketplace are only some of the things that have added to the fiercely competitive nature of business in the '90s.

Compound these realities with the ever-increasing threat of fraud to corporate coffers and there is reason for concern.

It is estimated that fraud and white collar crime cost the U.S. economy billions of dollars a year. Fraud has been referred to as one of the fastest growing industries in the United States. A recent study by the Association of Certified Fraud Examiners esti-

mates the cost of fraud as 2 to 5 percent of the gross domestic output or between \$132 billion and \$330 billion per year. The occurrence, complexity and dollar value of frauds committed against corporations, governments and individuals, both in this country and abroad have increased in recent years.

These sobering numbers almost demand an introduction to the

world of forensic accounting for corporate lawyers, in-house counsel and business lawyers who are often "first on the scene."

First, Case Study No. 1.

A medium-sized metal smelting business owned as a joint venture between two multinational corporations had been extremely profitable for many years. The joint-venture partners allowed Smelt Co. to operate independently and were satisfied to let local management run the show with little corporate interference. This continued as long as hefty dividends flowed upstream to the partners each year.

Management ran the company like a private empire, independent of its owners, other than the occasional board meeting and annual distribution of profit. Then Smelt Co. started losing money at a furious pace for no apparent reason.

A senior board member representing one of the partners thought that something must be wrong and suggested that the company's most trusted corporate lawyer look into the matter. The lawyer felt that an audit, or at a minimum a discussion with Smelt Co. executives, could help clear up the matter—or at least identify the problem, if any.

After a couple of hours of informal discussions with key management personnel, the lawyer was starting to feel less comfortable that he could report back to the board. Management claimed the business had taken a nose dive because of dropping metal prices and a smelter fire.

The lawyer thought: "Metal prices had dropped, but could that explain the drastic change in profitability? The smelter fire had happened quite recently, after the losses started piling up, and didn't someone mention excess capacity in some of the older smelters? The joint venture had received a 'clean audit' opinion for the last

three years. Am I missing something here?"

Over lunch in the law firm's cafeteria, the lawyer described his problem to one of his partners, a bankruptcy lawyer who had worked with forensic accountants in the past. The partner suggested engaging a forensic accountant to assist in an internal corporate investigation.

What followed was an intensive, 30-day investigation that revealed kickbacks from suppliers, undisclosed related-party transactions, excessive expenditures on personal items and an elaborate scam to divert corporate opportunities and profits to a business owned by management. The investigating team reported to the board at the end of the 30 days and the board decided to suspend management pending the outcome of the investigation.

The largest scam discovered was a parallel operation owned by the management team that was used to divert raw materials and profits from the business. This scam was revealed by reviewing purchase invoices for raw materials. These invoices were for goods purchased and paid for by Smelt Co., however, they had been shipped to an off-site warehouse.

Informal interviews with plant personnel helped confirm that these materials were processed and sold directly from the "other warehouse." Some digging and a visit to the local tax assessor's office revealed that the warehouse was owned by two members of the management team. Of course, revenues from the sale of these goods were not recorded on Smelt Co.'s books. The fraudsters in this case were so bold that they charged the rent for the warehouse to Smelt Co.

The investigation showed a scam designed to lead the business to the brink of financial disaster so that the management team

could buy the assets at below-market prices. Apparently, a supplier was going to finance the management buy-out and take an ownership interest in the new entity. Shortly after the scheme unraveled, the supplier—who had been involved in other questionable transactions—was found shot to death at his business. Nothing was stolen and there was no evidence of a break-in.

Pretty chilling, eh? So what are some of the basics that every corporate lawyer and in-house counsel should know about forensic accounting?

The term forensic accountant has grown out of accounting evidence used in court similar to that for the forensic document examiner and the forensic pathologist. In fact, the majority of matters that forensic accountants work on never make it to court or are never intended for court. However, the term remains; work performed by a forensic accountant is oriented to a high level of scrutiny.

Although **auditors** and forensic accountants share many of the same skills, their goals, experiences, objectives and the framework in which they work are extremely different. One of the primary differences between a financial statement audit and a forensic accounting investigation relates to overall objectives.

The overriding goal of the annual financial-statement audit is to provide an opinion on financial statements prepared by the company's management. The audit report reads, "...In our opinion, the financial statements...present fairly, in all material respects, the financial position of the company...". Many of the practices and procedures applied during an audit are *not* designed to detect frauds. Financial-statement auditing is intended to highlight deviations and variances from accounting

standards and stated internal-control policies.

When frauds are committed by overriding or bypassing controls, or when fraudulent transactions are disguised or covered up, the auditor may not become suspicious. In addition, financial accounting and financial-statement audits are governed by GAAP and GAAS—Generally Accepted Accounting Principles and Generally Accepted Auditing Standards.

Forensic accountants rely heavily on intuition and experience.

Forensic and investigative accounting is goal oriented. Forensic accountants may find themselves hired to:

- investigate an allegation of fictitious transactions being recorded in a brokerage house;
- review and investigate the investing activities of a municipal fund money manager;
- determine if the information relied on by an investment bank misrepresented the financial position of the target company, and if so, how, and what was the impact?

Not only are the goals of auditing and forensic accounting widely different, but the approaches can also differ to a great degree. Auditing includes a predetermined set of tests and procedures performed based on the assessments of various levels and forms of risk. Forensic accounting is a more intuitive process.

Forensic accounting services differ from traditional **litigation accounting** services (often referred to as litigation support) in that the latter tend to be associated with the calculation of *damages*, while the emphasis in forensic accounting is on financial investigations.

Some of the most interesting and challenging cases require the ability to successfully combine the investigative mentality

required in forensic accounting assignments and the analytical expertise needed in the arena of damage calculations.

Now, Case Study No. 2.

This case involved nine cousins and a real estate empire started by their recently deceased grandfather. Eight of the cousins ranged from 45 to 19 years old with the last cousin being an infant from a second marriage. Of course, the youngest cousin had not been corrupted and was not really involved in the case other than being a passive plaintiff on various motions.

The grandfather, keeping the best interests of his children and grandchildren in mind, established various real estate trusts for his heirs as his empire grew. As is the case with many family-owned companies, growth created opportunity for other family members to join the business.

His son-in-law joined the firm early on and had the skill and talent to assist his father-in-law during the primary years of growth. The founder had another son who became a doctor and never expressed an interest in the business even though he was a shareholder. Like their father, the doctor's children were never active in the business. Their cousins, on the other hand, followed their father and grandfather into the business.

At the instigation and direction of the oldest cousin (who worked in the business), a complex scheme of transactions, in-dealing, fraud and misrepresentation resulted in one group of cousins being unfairly enriched and one group being hung out to dry.

The greedy cousins not only diverted funds from trusts in which they were joint beneficiaries, but also incorporated various operating entities and holding companies to hijack certain corpo-

rate opportunities from the parent real estate firm—in some cases with the knowledge of their father and in other cases without his knowledge. For some of these undisclosed real estate deals, they even managed to obtain financing through the parent company.

Certain trusts had provisions for the distribution of income; however, the terms of these trusts were not explicitly followed. Funds tended to be distributed on a need basis, with the oldest cousin influencing the trustees. All of the trustees were family members. Therefore there were many personal and family relationships that ultimately affected the management of the trusts.

In addition to the hijacking of corporate opportunities and the unequal distributions from the trusts, the oldest cousin had undisclosed interests in suppliers and a series of undisclosed loans from the company.

During the course of a drawn-out legal battle, forensic accountants were engaged to assist two of the cousins with their investigation. The investigation and financial analysis went back 12 years, to the date the oldest cousin became involved in the business. The financial analysis and investigation uncovered unequal distributions from the various trusts, inflated salaries and bonuses paid to certain family members and the value of certain undisclosed transactions. The investigators also analyzed the potential diminution of value to the trusts caused by the greedy cousin's activities.

In this case study, the combination of investigative procedures, financial analysis and business-valuation skills resulted in the preparation of a concise, supportable damage calculation.

There are three critical ingredients in the recipe for fraud. They may be present in different degrees, but every fraud case will

include them in one way or another.

The **pressure** to commit a fraud generally comes from two sources—personal or organizational. Personal pressures relate to the specific situation of the fraudster. Personal pressure could include such financial pressures as greed, living beyond one's means, a need for quick cash caused by a divorce or other personal matters.

Organizational pressures relate to stress placed on the fraudster by the organization. One common organizational pressure placed on financial executives is the need to meet budgets and targets. In some cases, the consequences of not meeting these targets is so severe that the individual feels extreme pressure to do whatever it takes to avoid the negative consequence. For example, the manager who knows that if she "does not make budget," she will have to reduce her head count by four.

This organizational pressure may be so great that it causes the manager to perpetrate a reporting fraud by overstating the results of her business unit or division.

The **opportunity** to commit fraud is broad and comes in many different forms. Typically, in accounting-related frauds, individuals consider the opportunity to commit fraud—the lack of internal accounting controls and the lack of security over assets. For example, the employee who has custody over assets and controls record keeping has the opportunity to commit a fraud. Consider the warehouse manager who has custody of the inventory and also has access to the inventory accounting records. He would be in a situation to remove inventory from the warehouse and alter the records to reduce inventory quantities "on the books."

Management is continually trying to balance the cost and benefit of various alternative accounting controls in their organization. The controls cannot be so onerous that by decreasing the risk of fraud or loss to very low levels, they put the business in a noncompetitive situation in its marketplace.

Integrity refers to the ability of the potential fraudster to rationalize the fraudulent act. If an indi-

vidual has a low level of integrity, he or she may practice self-delusion and believe that an act is not improper. The manager who abuses an expense account by claiming expenses twice or claiming non-business expenses may say, "I work harder than Joe and get paid the same." The accounting executive who embezzles cash from an employer may be able to rationalize that "I am just borrowing the funds and will pay them back."

The three ingredients move along parallel continuums in a delicate balance. When the balance is not upset, or one element counteracts the other, no frauds are committed. For example, a fraud will likely take place when an employee has a high level of personal pressure to commit a fraud, a low level of personal integrity and opportunity exists through poor internal controls. However, a fraud will likely *not* occur if there is moderate personal pressure and opportunity, but the individual's level of integrity acts as a counterbalancing force.

So where does the future lead?

The role of forensic accountants is not limited to probing financial disasters. They are starting to have preventive roles as well. Their experience and mindset suits them as members of due-diligence teams for mergers and acquisitions, corporate monitors for regulatory or court-imposed compliance terms as well as preinvestment investigations. **BLT**

What to look for when hiring a forensic accountant:

- experience relevant to your case
- professional qualifications
- references from other lawyers/clients
- common sense/street smarts
- business sense
- curiosity/inquisitiveness/perseverance
- listening skills
- communication skills (*Can he or she explain complex transactions in clear, understandable terms?*)
 - independence/objectivity
 - cost consciousness
 - presence/credibility/jury appeal (*Is the accountant a likable witness?*)
 - compatibility (*Will you have fun working with the individual or group?*)
 - durability (*Will the individual withstand the rigors of the case and possible depositions/trial?*)

Reprinted by permission.